

# The Effect of Firm Performance on Annual Report Readability

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**Keywords:** Gunning Fog Index, Readability, Firm size, Firm age, Firm Performance.

**Abstract:** This study aims to examine whether there is an effect of firm performance on the readability of the annual report and how the influence between these variables. This study uses a sample of companies with various industrial sectors listed on the IDX for 2017-2019 period. The number of samples used as many as 114 companies. The independent variable in this study is expressed by the company's performance using Tobin's Q value and the dependent variable is expressed by the readability of the company's annual report using gunning fog index. This study also uses control variables that are proxied by the size and age of the company. The data processing in this study uses SPSS version 20. The results of the hypothesis indicate that the company's performance influences on the readability of the company's annual report. Companies with high performance get a high readability value of the annual report as well. This is due to the increasing size of the company's operations so that the company offers a more detailed explanation. The high age of the company does not affect the readability of the annual report. The conclusion of this study states that other factors have more influence on the readability of the annual report.

## 1 INTRODUCTION

PT. The Indonesia Stock Exchange, as one of the regulators and trade organizers in the Indonesian capital market, provides data services for trading stocks, bonds, and derivatives. The Law of the Republic of Indonesia Number 8 of 1995 in CHAPTER III states that the Indonesia Stock Exchange provides supporting facilities and reviews the activities of members of the Indonesia Stock Exchange and has the objective of conducting orderly, fair, and efficient securities trading. The Indonesia Stock Exchange makes it easy for parties such as investors, creditors, and others to easily access financial reports and annual reports.

Financial statement information is one of the important things for investors as an object of decision-making analysis seen from stock movements, company profitability, quality of financial performance, and prospects of the company (Fatmasari, Sulistiyo, & Mustikowati, 2014). The results of the analysis of the financial statements will provide a signal to investors whether the investment made in the future will benefit or vice versa. Apart from financial reports, investors can also carry out decision-making analysis through descriptive expressions in the company's annual report.

The company's annual report is currently changing by including more information in the form of narrative text with a scale of 80% disclosure and the rest is representative quantitative data (Lo, Ramos, & Rogo, 2017). This is due to the development of variations in annual reports for each period so that understanding the readability of the annual report can be said to be crucial. OJK Regulation Number 29 / PJOK.04 / 2016 states that annual report information is presented in the form of narrative text which is elaborated through written submissions of the board of directors, the board of commissioners, the profile of the issuer, management discussion, and analysis, corporate governance, social responsibility, and statements of members of the board of directors as well as explanations related to quantitative data are presented through a summary of important financial data, stock information and also audited financial reports.

According to the Big Indonesian Dictionary (KBBI), legibility is about being able to read text quickly, easily understand and remember. Readability can also be said as an aspect used in regulating and assessing a company. In PSAK Number 1 regarding the presentation of financial reports and the Regulation of the Financial Services Authority Number X.K26 part II, it states that the

annual report must be made in such a way that it is not difficult to read and easy to understand.

Companies that publish easy-to-read annual reports will be very useful for users to understand how the company is performing in a certain period, which is conveyed through the company's annual report. Financial report users who do not understand accounting can analyze the company's performance through the narrative text of the company's annual report. This is also reinforced by a statement (Lehavy, Li, & Merkley, 2011) which states that financial reporting narratives are needed for investors who have limited knowledge of accounting or finance. Investors who have minimal knowledge have difficulty understanding the meaning of numbers in financial reports and decide to collect more information from the narrative text provided (Rohmawati, 2020).

As a representative candidate for the company, management must provide information regarding the company properly and correctly as a form of matter that can be trusted by investors. Each period the management will project a profit target to be achieved, but due to uncertain economic conditions, the company does not always succeed in getting large profits and even may suffer losses from several causes that cannot be controlled by the company. Companies with poor performance translate their performance using language and meaning that is difficult to understand (Subramanian, Insley, & Blackwell, 1993). This statement is linear with research (Li, 2008) which states that annual reports that are difficult to understand occur in companies with low profits.

Several researchers have conducted research related to readability with different results caused by differences in measurement variables and proxies. Research development is carried out in this study. Research related to readability in Indonesia has also been carried out by (EDT, Febrianto, & Rahman, 2018) regarding the relationship between company performance and the readability of the company's annual report. The company's performance becomes the independent variable and the readability of the annual report is expressed as the dependent variable. The study used a sample of 1,222 annual reports of companies listed on the IDX from 2013-2017. Company performance measurement using ROA, ROS, and ROE and readability is measured by Gunning Fog Index. The results show that the company's performance has no effect on the readability of the annual report but ROS has an effect on the readability of the company's annual report. The study stated that the company's performance in the

form of high return on sales (ROS) resulted in the readability of the annual report which focused on the report of the board of directors to be easily read.

Previous research was conducted by (Gu & Dodoo, 2020) on the effect of firm performance on the readability of the annual reports of companies listed on the Ghana Stock Exchange (GSE) for the period 2008-2017. The results found that corporate governance harms the readability of the company's annual report and for firm performance has a positive effect on the readability of the company's annual report. The study states that other determinants have a relationship with legibility, so this study adds the implication of firm age as one of the factors that may influence the readability of the company's annual report. Rationally, a company that has been established for a long time will have a more complete annual report because it has more experience than a company that has only been running for a few years.

Another difference from previous research occurred in selecting a sample of companies by focusing on the miscellaneous industry in Indonesia and taking the latest period issued by the IDX from 2017-2019. This is because based on IDX Yearly Statistic 2017-2019 data, this sector has experienced an increase in the value of PER (price to earnings ratio), which is the company's annual profit rate against its share price. It can be considered that this sector has a good ability in firm performance and will rationally have good readability of annual reports. On the other hand, with these good points, a company can also succeed in hiding its bad performance so that the readability of the company's annual report is needed.

The research contribution of this research literature is practically focused on companies paying more attention to legibility so that users of annual reports can easily interpret the information presented. Users of company annual reports can pay more attention to the legibility of the annual reports issued. Theoretically, this research is expected to be able to increase understanding of the determinants of readability and can be used as a reference for other studies.

## 2 THEORETICAL STUDY

### 2.1 Agency Theory

Agency theory begins with the separation between company owners and management (Priguno & Hadiprajitno, 2013). Statement (Jensen & Meckling, 1976) states that there are two forms of agency

relationships, namely the relationship between managers and shareholders and the relationship between managers and lenders (bondholders). Agency theory can be viewed as a contractual model between two or more parties, namely the principal and agent. The principal delegates responsibility for the company's decision-making to the agent so that the agent is given the mandate to carry out tasks based on a properly executed contract agreement between the two parties.

Eisenhardt (1989) stated that agency theory involves three assumptions of human behavior, first is that humans are usually selfish, secondly, humans have limited thinking capacities and third humans always avoid risks. One of the reasons for management to avoid risk is that they do not want their weaknesses to be seen by other parties. Agency problems arise when the principal (investor) finds it difficult to guarantee that the agent (management) acts to maximize their welfare (Yushita, 2010). Ownership of information held by managers can trigger activities by following per under the wishes and personal interests of management so that capital owners find it difficult to effectively supervise activities carried out by management because of the limited information they have. Certain policies carried out by company management are sometimes also carried out without the knowledge of the owner of the capital so that differences in ownership of information held between the two parties lead to misalignment of information or information asymmetry (Cahyaningtyas & et al, 2017). Conflicts related to information asymmetry can be minimized by disclosing good and correct company reports to the principal as a form of transparency of management performance.

## 2.2 Readability Theory

The readability of narrative text disclosures in annual reports is one of the important matters for annual report users in assessing a company (Prasadhita, 2018). The relationship between accounting narrative information in legibility is defined as the percentage of success and difficulty in communicating accounting information (Hidayatullah & Setyaningrum, 2018). Narrative information has a function to convince users of financial statements about the condition of the company.

Readability theory was put forward by Robert Gunning in 1952. The theory became known as gunning fog index which was used to see the level of legibility of the text. According to (Christanti, Naga, & Benedicta, 2017) Gunning Fog Index has a function as a guarantee that the readability of the text can be understood by readers so that it is considered important to test the readability of the annual report.

## 2.3 Signal Theory

Signal theory was first put forward in a study entitled Job Market Signaling by Michael Spence in 1973. The involvement of management who has a role as the party giving the signal and outside management as the party receiving the signal is the purpose of this theory. Rationally, an investor will make predictions before deciding on investment by observing the signals given by the company. This theory is based on the asymmetric information held between the internal parties of the company who have more information related to the company than the external parties, including investors.

Ross developed this theory in 1977 by stating that better company information encourages executives to convey this information to investors as well as potential investors. Good presentation and disclosure of information can be assessed from the completeness and accuracy of the data which is then used by interested parties for decision making. According to external parties, companies with good corporate values will provide good signals.

## 2.4 Hypothesis Development

### 2.4.1 Effect of Firm Performance on Readability of Annual Reports

The readability of the presentation of the annual report is the responsibility of management to stakeholders which will then be used as material for decision making. As the owner is entrusted with running the company, the manager will make efforts to improve the company's performance by following per the owner's wishes. Reports with a good performance level only need to interpret the information according to the reality of the existing conditions without extending the reasons for achieving good or bad performance (EDT, Febrianto & Rahman, 2018). When companies have low performance, they will take several actions to manipulate accounting numbers or attribute bad news (Lo, Ramos, & Rogo, 2017). The hypothesis in this study is as follows:

#### **H1: Firm Performance Affects the Readability of the Annual Report**

Based on the description of the theoretical study, literature review, and hypothesis development that have been described previously, the research model can be seen in Figure 1:

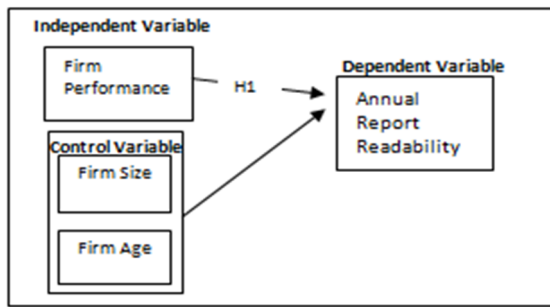


Figure 1: Research Model

### 3 RESEARCH METHOD

This research is a quantitative study to provide evidence of the effect of firm performance on the readability of the company's annual report. Secondary data on company annual reports published on the Indonesia Stock Exchange (IDX) for 2017-2019 period through the website [www.idx.co.id](http://www.idx.co.id) and the company's official website was used as the source of data in this study. The population used as the sample of this study consists of companies with the miscellaneous industry sector for the period 2017-2019. This study uses three variables, namely the dependent variable, the independent variable, and the control variable. The type of data in this study used cross-section data because the independent variables were not influenced by the previous year's report data or afterward.

#### 3.1 Operational Definition

##### 3.1.1 Dependent Variable

The dependent variable is stated by the readability of the annual report. To measure the readability value of the company's annual report in this study using gunning fog index measurement which has been widely used by several previous researchers such as (Lo, Ramos, & Rogo, 2017), (Gu & Dodoo, 2020), and (EDT, Febrianto, & Rahman, 2018) taking into account the relevance of legibility complexity. Gunning Fog Index is a linguistic computing system that was first created by Gunning in 1952 to help staff in environmental companies improve their communication relationships through writing. (Gu & Dodoo, 2020). Fog Index is an easy system with calculating the average sentence length (comparison of the number of words to several words) and the average difficult words (comparison of several some many words with several some many complex

words). This research uses the web [www.gunning-fog-index.com](http://www.gunning-fog-index.com) which is used for the time efficiency of manual calculations. The form of the formula for calculating legibility using gunning fog index comes from:

##### Gunning Fog Index formula

$$Fog = 0.4 \times (\text{word per sentence}) + 100 (\text{complex word per word})$$

Source: (Gu & Dodoo, 2020)

If the value,  
 Fog  $\geq$  18 : complex text  
 Fog 18-14 : unreadable text  
 Fog 14-12 : ideal text  
 Fog 12-10 : acceptable text  
 Fog 10-8 : easy to read text afterward.

##### 3.1.2 Independent Variable

The independent variable is stated by the company's performance as measured using Tobin's q by comparing the accumulated stock market value and debt market value divided by the total value of capital placed on assets. Tobin's q value illustrates the performance of management in utilizing company assets. This measurement measures whether the company is experiencing growth, steady or even declining (Rengga & Sukamulja, 2015). A high q ratio value means that the company has a competitive advantage or tends to have attractive investment opportunities (Rengga & Sukamulja). Here is the formula for Tobin's q:

##### Tobin's q formula

$$q = (MVS + MVD) / RVA$$

Source: (Rengga & Sukamulja)

Information:  
 MVS: closing price x number of shares outstanding  
 MVD: book value of total debt  
 RVA: Change the value of the overall production capacity

- \* Tobin's q < 1 denotes an undervalued stock
- \* Tobin's q = 1 represents the stock average
- \* Tobin's q > 1 indicates the stock is overvalued

### 3.1.3 Control Variable

#### Firm Size

The first control variable in this study is stated by the size of the company. Measurements are made by calculating the company's total assets. The size of the company shows the progress of a company so that investors are likely to respond well and the company value will increase (Sujoko & Subiantoro, 2007).

#### Firm Age

The second control variable in this study is stated by the age of the company. The measurement of the age of the company can be calculated from the time the company is founded. According to (Roiston & Harymawan, 2020) older companies have sufficient skills and experience in managing company annual reports.

### 3.2 Data Processing Techniques

Four stages need to be done in the data processing. First, identify the variables that will be used. Second, tabulating the data into Microsoft Excel. Third, providing coding to shorten element names. Fourth, re-checking the data that has been inputted. Fifth, data processing using SPSS software version 20. The method of analysis in this study uses descriptive statistics, classical assumption tests, multiple linear regression analysis, and hypothesis testing. The regression models in this study are:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + e$$

Model 1:

$$\text{Annual Report Readability (MD\&A)} = 0.360 + 0.032 \text{ Tobin's } Q + 0.428 \text{ Firm Size} + 0.015 \text{ Firm Age} + e$$

This research was conducted in Indonesia through data collection on the Indonesia Stock Exchange through the existing official website. The choice of location is because the Indonesia Stock Exchange has a draft of going public companies in Indonesia. The object of this research is the company's annual report which includes financial information as well as management discussion and analysis which is used as research measurement material.

## 4 RESULT

The data population in this study are companies with the miscellaneous industry sector in Indonesia which are listed on the Indonesia Stock Exchange with 2017-2019 period with a total of 156 companies. The sample taken is the whole of the population which among some of the data is not sampled due to certain reasons. In addition, outlier data in the study were also not sampled because these data had values that were far different from other data (extreme values) which could bias the data analysis process. The total sample as a whole that can be processed during 2017-2019 period is 114 companies. The number of samples for this research can be seen in Table 1 as follows:

Table 1. Final Sample Firm

| Criteria   | 2017 | 2018 | 2019 | Total |
|--|------|------|------|-------|
| List of companies on the IDX 2017-2019                       | 52   | 52   | 52   | 156   |
| Companies that do not provide complete data during 2017-2019 | (5)  | (11) | (13) | (29)  |
| Companies that present unprocessed MD&A Report               | (0)  | (1)  | (3)  | (4)   |
| Data of companies experiencing outliers                      | (4)  | (3)  | (2)  | (9)   |
| Final Sample Firm  | 43   | 37   | 34   | 114   |

### 4.1 Descriptive Statistical Analysis

Below is a descriptive statistical analysis table:

Table 2: Descriptive statistical table

| Variable  | Mean    | Max        | Min      | Std. Dev |
|-----------|---------|------------|----------|----------|
| TQ        | 3.54790 | 70.870     | .2500    | 10.83816 |
| FS        | 28.1578 | 30.710     | 25.22    | 1.261920 |
| FA        | 37.3800 | 103.00     | 9.000    | 17.73800 |
| FI        | 13.0682 | 17.300     | 8.620    | 1.905360 |
| Residual  | .00000  | 5.03066    | -3.72119 | 1.77510  |
| Valid (N) |         | <b>114</b> |          |          |



### Tobins' Q

Tobin's Q with the formula of market capitalization plus the total amount of debt divided by the total number of assets is used as a measure of firm performance which is an independent variable from the study which has an average of 3.5479 and std. a deviation of 10.83816 from 114 companies. With this average number, it can be concluded that stocks in the miscellaneous industry sector from 2017-2019 have been overvalued because of the average value of Tobin's Q > 1. The maximum value is at PT Ricky Putra Globalindo Tbk (RICY) in 2017. This is because The largest market capitalization among companies in the miscellaneous industry sector in 2019 with a nominal value of 96,258,000,000,000, total debt of 941,305,576,442 and total assets of 1,371,570,948,138. With the results of this capitalization, it was stated that the shares of PT Ricky Putra Globalindo in that year were overvalued and the company's performance level was 70.87. The minimum value is at PT Selamat Sempurna Tbk in 2017 with a market capitalization value of 7,227,137,677, total debt of 615,157,000, total assets of 171,333,000,000. These results stated that the shares of PT. Selamat Sempurna Tbk experienced undervalued and the company's performance level was 0.25.

### Fog Index

Gunning Fog Index is a proxy for measuring the readability of the company's annual report as the dependent variable, which shows that the average readability of the company's annual report is 13.0682 and the std value. a deviation of 1.90536 for 114 companies. It can be concluded that the average text readability of MD&A in the annual report of companies with the miscellaneous industry sector is categorized as ideal. The highest readability value occurred at PT Uni-Charm Indonesia Tbk in 2019 with a value of 17.30% or it can be said that it is difficult to read and a low readability value occurred at PT Steadfast Marine Tbk in 2019 with a value of 8.62% or it can be said that the text is acceptable.

## 4.2 Determination Coefficient Test

This test aims to determine whether the independent variable can explain the dependent variable in the study. The results show that the value of R Square is 0.363 and Adjust R Square is 0.132. It can be concluded that the firm performance variable can explain the readability of the company's annual report but cannot explain it as a whole because the value is still far from one or if it is only able to explain as much as 1.32% which is considered there are other aspects as much as 8.68% who will be able and can explain more. readability of the report. The results of

the test of the coefficient of determination can be seen in Table 3 as follows:

Table 3: Determination Coefficient Test

| R Square | Adjust R Square | Decision                                  |
|----------|-----------------|---|
| 0.363    | 0.132           | Be able to explain the dependent variable |

## 4.3 Partial Hypothesis Test

The result of partial hypothesis testing statistically shows that the significant value of the firm performance variable which is expressed in Tobin's Q value has a sig value. Amounting to 0.044 which is valued at  $\leq 0.05$  with a positive t value of 2.036. The independent variable, namely firm performance as measured using Tobin's Q, has a positive effect on the readability of the company's annual reports in the discussion and analysis management section of the company. So that H1 in this study can be supported. The results of hypothesis testing can be seen in Table 4 as follows:

Table 4: T-Test (Partial)

| Variable  | T     | Sig. | Decision             |
|-----------|-------|------|----------------------|
| Content   | .095  | .925 | 0,5207               |
| Tobin's Q | 2.036 | .044 | Hypothesis Supported |

Based on the research that has been done, it was found that the disclosure of company information with high performance is different from the disclosure of companies with low performance. Companies with high performance get a high readability value of the annual report as well. This is due to the increasing complexity of the company's operations so that the company offers more detailed explanations by translating sentences into longer narrative information and using more words. The complexity is seen from the high market capitalization, total debt and total asset ownership. This is in line with previous research conducted by (Rohmawati, 2020) which supports the hypothesis of this study. In the study, it was stated that the higher the financial performance of a company, the more complex the report on the company's responsibilities. And the results of this study are also in line with previous research conducted by (Gu & Dodoo 2020), the results of this study state that the company's performance variable has a positive effect on the readability of the company's annual report. The high and low

readability of the annual report will have an impact on the company's stakeholders. According to the conclusion of research conducted by (Lee, 2012) disclosure of more complex information will require investors to use deeper thinking. The company as the party that prepares the annual report needs to understand that the readability of the information in the report is an important thing that will be used by investors. This complexity will reduce the ability and understanding of stakeholders in evaluating the company's prospects based on the delivery of such information which will have an impact on decreasing decision results. The results of the decline in decisions made by investors can be wrong or even distorted, which will then affect the company itself. Therefore, the complexity of delivering information does not need to be done because it will make it difficult for investors to make decisions.

## 5 CONCLUSION

Based on the research results, it can be concluded that the company's performance has a positive effect on the readability of the company's annual report. This explains that the higher the company's performance, the higher the readability value of the annual report. The use of control variables in this study to minimize or eliminate other influences between the independent variable and the dependent variable. The results show that companies have been around for a long time or have been established does not effect on readability of annual report. The results of this study are expected to add references to the literature on research that discusses the effect of firm performance on the readability of annual reports. The results of this study are also expected to be reference material for decision-making for stakeholders and investors who wish to invest in stocks. The research has limitations, namely:

- a. This study only includes companies with the miscellaneous industry sector that are listed on the IDX.
- b. Taking the period in this study starts from 2017-2019 so that the research cannot be generalized to the previous year or the year after.
- c. The independent variable, namely the company's performance in this study, is only measured from the point of view of Tobin's Q value, which has not been able to optimally explain the legibility of the company's annual report.

- d. The dependent variable in this study uses gunning fog index to measure the readability of the company's annual report.
- e. The involvement of control variables in this study only uses the size and age of the company.

From the limitations of this study, there are several suggestions for further research including further research is expected to expand the research sample not only to one sector but to cover the entire sector, add other variables and other proxy differences to see what factors have an influence or effect. it even has a strong influence on the readability of the company's annual report and the timing for further research is expected to use the most recent time issued.

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